EAA, EFRAG and IASB participants

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Tobias Bornemann, Vienna University of Economics and Business

Annelies Renders, BI Norwegian Business School

Florian Esterer, IASB member

Riana Wiesner, IASB Technical Director

Angie Ah Kun, IASB Technical Staff
Objective of this workshop


• To highlight academic research that is relevant to the proposals in the Exposure Draft

• To stimulate academic research in areas where there are gaps in the academic literature
Financial Instruments with Characteristics of Equity (FICE)

Riana Wiesner (rwiesner@ifrs.org)
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Purpose of this session

• Provide an overview of:
  • the FICE project;
  • the presentation proposals with illustrative examples; and
  • the disclosure proposals with additional explanation and illustrative examples.
Overview of the project

Improve information entities provide in their financial statements about financial instruments that they have issued

Approach:
- Improve presentation and disclosure
- Address practice issues by clarifying underlying classification principles
- Provide application guidance and illustrative examples

Address challenges in applying IAS 32:
- The effects of relevant laws or regulations
- Fixed-for-fixed condition for derivatives
- Obligation to purchase an entity’s own equity instruments
- Contingent settlement provisions
- Shareholder discretion
- Reclassification of financial liabilities and equity instruments

A snapshot and webcast series is also available on our website.
Next steps

29 Nov 2023
Exposure Draft published

29 Nov 2023–29 Mar 2024
Consultation period

Q2 2024 onwards
Feedback analysis and redeliberations

Link to the consultation:

Consultation closes 29 March 2024
Perpetual instruments

‘In good times, behaves like debt, in bad times, behaves like equity.’
- Stated coupon
- Issuer call option
- Coupon and principal can be deferred
- Subordinated/loss absorption

What is the IASB proposing?
- No change in classification
- Develop presentation and disclosure requirements

Regulatory Capital
- Restricted Tier 1 (RT1)
- Additional Tier 1 (AT1)

Corporate Hybrids
- Utilities
- Telecommunication
- Oil and Gas
- Automobile

Regulatory Environment
- A change in accounting classification is not expected to affect the regulatory capital classification

Feedback from equity investors
- Most equity analysts preferred financial liability classification
- If equity classification is retained, separate presentation and additional disclosures in the notes would provide useful information

In good times, behaves like debt, in bad times, behaves like equity.'
Presentation proposals
To ensure amounts attributable to ordinary shareholders are clearly visible on an entity’s statement of financial position, statement(s) of financial performance and statement of changes in equity, an entity will be required to present:

**Equity**

- Ordinary shareholders of parent
- Other owners of the parent

**Balance sheet**
- Line items on issued capital and reserves shown separately

**Statement of financial performance**
- Results attributable shown separately

**SOCIE**
- Each class of contributed equity shown separately
- Distribution shown separately
### Statement of profit or loss (extract)

<table>
<thead>
<tr>
<th></th>
<th>2020 CU million</th>
<th>2019 CU million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit attributable to:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary shareholders of the parent</td>
<td>82,000</td>
<td>39,400</td>
</tr>
<tr>
<td>Other owners of the parent</td>
<td>15,000</td>
<td>13,000</td>
</tr>
<tr>
<td>Non-controlling interests</td>
<td>24,250</td>
<td>13,100</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>121,250</td>
<td>65,500</td>
</tr>
</tbody>
</table>

### Balance sheet (extract)

<table>
<thead>
<tr>
<th></th>
<th>2020 CU million</th>
<th>2019 CU million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>642,000</td>
<td>600,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>200,500</td>
<td>127,700</td>
</tr>
<tr>
<td>Other reserves</td>
<td>10,200</td>
<td>21,200</td>
</tr>
<tr>
<td>Equity attributable to ordinary shareholders of the parent</td>
<td>852,700</td>
<td>748,900</td>
</tr>
<tr>
<td>Equity attributable to other owners of the parent</td>
<td>51,000</td>
<td>34,000</td>
</tr>
<tr>
<td>Non-controlling interests</td>
<td>70,050</td>
<td>48,600</td>
</tr>
<tr>
<td>Total equity</td>
<td>973,750</td>
<td>831,500</td>
</tr>
</tbody>
</table>

Proposed improvements to presentation in the financial statements
Illustrative presentation (continued)

<table>
<thead>
<tr>
<th>Statement of changes in equity (extract)</th>
<th>Share capital</th>
<th>Retained earnings</th>
<th>Other reserves</th>
<th>Equity attributable to ordinary shareholders of the parent</th>
<th>Equity attributable to other owners of the parent</th>
<th>Non-controlling interests</th>
<th>Total equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 1 January 20X6</td>
<td>600,000</td>
<td>97,500</td>
<td>(400)</td>
<td>697,100</td>
<td>21,000</td>
<td>29,900</td>
<td>748,000</td>
</tr>
<tr>
<td>Changes in equity for 20X6</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>–</td>
<td>(10,000)</td>
<td>–</td>
<td>(10,000)</td>
<td>–</td>
<td>–</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Total comprehensive income for the year</td>
<td>–</td>
<td>40,200(a)</td>
<td>21,600</td>
<td>61,800</td>
<td>13,000</td>
<td>18,700</td>
<td>93,500</td>
</tr>
<tr>
<td>Balance at 31 December 20X6</td>
<td>600,000</td>
<td>127,700</td>
<td>21,200</td>
<td>748,900</td>
<td>34,000</td>
<td>48,600</td>
<td>831,500</td>
</tr>
<tr>
<td>Changes in equity for 20X7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issue of share capital</td>
<td>42,000</td>
<td>–</td>
<td>–</td>
<td>42,000</td>
<td>8,000</td>
<td>–</td>
<td>50,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>–</td>
<td>(9,000)</td>
<td>–</td>
<td>(9,000)</td>
<td>(6,000)</td>
<td>–</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Total comprehensive income for the year</td>
<td>–</td>
<td>81,600(b)</td>
<td>(10,800)</td>
<td>70,800</td>
<td>15,000</td>
<td>21,450</td>
<td>107,250</td>
</tr>
<tr>
<td>Transfer to retained earnings</td>
<td>–</td>
<td>200</td>
<td>(200)</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Balance at 31 December 20X7</td>
<td>642,000</td>
<td>200,500</td>
<td>10,200</td>
<td>852,700</td>
<td>51,000</td>
<td>70,050</td>
<td>973,750</td>
</tr>
</tbody>
</table>

(a) The amount included in retained earnings for 20X6 of 40,200 represents profit attributable to ordinary shareholders of the parent of 39,400 plus remeasurements of defined benefit pension plans of 800.

(b) The amount included in retained earnings for 20X7 of 81,600 represents profit attributable to ordinary shareholders of the parent of 82,000 plus remeasurements of defined benefit pension plans of 400.
Disclosure proposals
Disclosures—Proposed amendments to IFRS 7

Terms & Conditions
- Debt-like characteristics
- Equity-like characteristics
- Characteristics that determine the classification

Other disclosures
- Reclassifications
- Remeasurement gains or losses on liabilities based on entity’s performance/net assets
- Obligations to redeem own equity instruments
- Significant judgements
- Terms that become/stop being effective with passage of time
- Compound instruments–initial allocation between components

Priority on liquidation
- Nature and priority of claims against an entity
- T&Cs about priority on liquidation for particular instruments

Potential dilution
- Maximum number of additional ordinary shares
- Reduced by minimum number of shares for repurchase

Scope of IFRS 7
- Equity instruments issued
- Not applicable to stand-alone derivatives
Disclosures—terms and conditions

Objective
Help investors better understand the nature, amount, timing and uncertainty of cash flows arising from issued financial instruments

Scope
• Financial instruments with characteristics of both debt and equity
• Includes compound instruments
• Excludes standalone derivatives

Requirements
Highlight:
• cash flow characteristics that are not ‘typical’ of the instrument's classification
• key features that determine classification
• the amounts allocated initially to the financial liability and equity components of compound financial instruments
Debt-like characteristics in equity instruments

Even though the entity has no contractual obligation to deliver cash, contractual terms:

• give rise to cash flows that have similar characteristics of nature, timing or amount to those of a financial liability; or

• may cause an entity to deliver debt-like cash flows.

• For example, preference shares not redeemable by the holder, classified as equity because the entity has the contractual right to avoid/defer payment until liquidation.
• Debt-like characteristics—fixed cumulative coupon amounts, specified coupon payment dates and fixed principal amount.
For example, a financial liability that requires an entity to settle the instrument by delivering a variable number of own shares to the holder.
Terms and conditions illustrative disclosure

Perpetual subordinated notes

At 31 December 2020, the total perpetual subordinated notes outstanding amounted to CU3,986 million and are included in Company X’s equity. The table below includes the **key terms of these financial instruments.**

<table>
<thead>
<tr>
<th>5.5% Fixed Rate Subordinated Notes</th>
<th>Notional amount</th>
<th>Initial call date</th>
<th>Coupon reset after initial call date</th>
<th>2020 CU million</th>
<th>2019 CU million</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD 1,000m</td>
<td>January 2025</td>
<td>10.5%</td>
<td>690</td>
<td>714</td>
<td></td>
</tr>
<tr>
<td>4.5% Fixed Rate Subordinated Notes</td>
<td>EUR 750m</td>
<td>March 2028</td>
<td>Market rate</td>
<td>647</td>
<td>658</td>
</tr>
<tr>
<td>4% Fixed Rate Subordinated Notes</td>
<td>EUR 2,000m</td>
<td>October 2032</td>
<td>Market rate</td>
<td>1,724</td>
<td>-</td>
</tr>
<tr>
<td>3% Fixed Rate Subordinated Notes</td>
<td>GBP 1,000m</td>
<td>January 2027</td>
<td>Market rate</td>
<td>925</td>
<td>910</td>
</tr>
</tbody>
</table>

Total: 3,986 2,282
Terms and conditions illustrative disclosure (continued)

**Coupon**

These notes bear a fixed rate of coupon until their initial call dates. After the initial call dates, if they are not redeemed, the coupon on the notes reset. The coupon on the USD subordinated notes reset to 10.5%. The coupon on the other notes are fixed periodically in advance for five-year periods, based on prevailing market interest rates plus credit spreads of Company X, fixed at issuance.

Company X has discretion to defer coupons on these notes. The deferred coupons accumulate and become payable at the call date if the notes are called, or when Company X is liquidated, if the notes are not called.

Company X is prevented from paying dividends or other distributions in respect of its ordinary shares, or from repurchasing its ordinary shares, until the cumulative coupons on the perpetual subordinated notes have been paid in full.
Terms and conditions illustrative disclosure (continued)

**Redemption option**

These notes are redeemable at the option of Company X at the initial call date or any fifth anniversary after this date. The amount redeemable will be the notional amount plus accumulated coupons.

**Classification**

These notes are classified as equity instruments because Company X has the unconditional contractual right to defer coupons and principal repayments until liquidation of Company X.
Disclosures–Priority on liquidation: nature and priority of claims

**Objective**
Provide information about nature and priority of claims against the entity that arise from financial instruments

**Scope**
All financial liabilities and equity instruments within the scope of IAS 32

**Requirements**
Categorise financial instruments by differences in nature and priority, distinguishing between:
- secured and unsecured
- contractually subordinated and unsubordinated
- issued/owed by parent and issued/owed by subsidiaries
Priority on liquidation illustrative disclosure

*Nature and priority of claims*

<table>
<thead>
<tr>
<th>As at 31 Dec 2020 (CU million)</th>
<th>Issued / owed by</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Consolidated</td>
</tr>
<tr>
<td>Secured and unsubordinated</td>
<td></td>
</tr>
<tr>
<td>Senior secured debt (a)</td>
<td>1,200</td>
</tr>
<tr>
<td>Lease liabilities (a)</td>
<td>920</td>
</tr>
<tr>
<td>Unsecured and unsubordinated</td>
<td></td>
</tr>
<tr>
<td>Trade and other payables</td>
<td>1,450</td>
</tr>
<tr>
<td>Senior unsecured debt (a)</td>
<td>450</td>
</tr>
<tr>
<td>Unsecured and subordinated</td>
<td></td>
</tr>
<tr>
<td>Subordinated liabilities (see note 15)</td>
<td>590</td>
</tr>
<tr>
<td>Classified as financial liabilities</td>
<td>4,610</td>
</tr>
<tr>
<td>Unsecured and subordinated</td>
<td></td>
</tr>
<tr>
<td>Perpetual notes (see note 18)</td>
<td>200</td>
</tr>
<tr>
<td>Irredeemable preference shares (See note 19)</td>
<td>400</td>
</tr>
<tr>
<td>Non-controlling interest</td>
<td>1,350</td>
</tr>
<tr>
<td>Other reserves</td>
<td>15,000</td>
</tr>
<tr>
<td>Ordinary share capital</td>
<td>8,500</td>
</tr>
<tr>
<td>Classified as equity</td>
<td>25,450</td>
</tr>
<tr>
<td>Total</td>
<td>30,060</td>
</tr>
</tbody>
</table>

(a) Included in the “Borrowings” line item in the statement of financial position.
Disclosures–Priority on liquidation: contractual terms about priority

Objective
Provide information about the risks and returns of financial instruments on liquidation of the entity

Scope
• Financial instruments with characteristics of both debt and equity
  • Includes compound instruments
  • Excludes standalone derivatives

Requirements
Disclose terms and conditions about priority of financial instruments on liquidation, including:
• terms that indicate priority
• terms that could lead to changes in priority
• details of intragroup arrangements such as guarantees
Priority on liquidation—subordinated notes

In the event of the respective issuer’s liquidation, any amounts due in respect of the subordinated notes rank junior to all present and future unsubordinated claims of the respective issuer and rank senior to the respective issuer’s ordinary shares, and if any, preference shares. Subordinated notes do not rank pari passu with one another. Some subordinated notes are contractually subordinated to other subordinated notes.

<table>
<thead>
<tr>
<th>Notes Description</th>
<th>2020 CU million</th>
<th>2019 CU million</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD 1,000m 5.5% Fixed Rate Subordinated Notes due January 2025</td>
<td>690</td>
<td>714</td>
</tr>
<tr>
<td>EUR 750m 4.5% Fixed Rate Subordinated Notes due March 2028</td>
<td>647</td>
<td>658</td>
</tr>
<tr>
<td>EUR 2,000m 4% Fixed Rate Subordinated Notes due October 2032</td>
<td>1,724</td>
<td>-</td>
</tr>
<tr>
<td>GBP 1,000m 3% Fixed Rate Subordinated Notes due January 2027</td>
<td>925</td>
<td>910</td>
</tr>
<tr>
<td></td>
<td>3,986</td>
<td>2,282</td>
</tr>
</tbody>
</table>
Disclosures—maximum dilution of ordinary shares

**Objective**
- Provide information about dilution that could arise from any potential increase in number of issued ordinary shares
- Not to replace IAS 33 Diluted EPS calculation

**Scope**
- All instruments and transactions settled by delivering ordinary shares
- Includes IFRS 2 instruments and transactions (entities can leverage existing IFRS 2 disclosures)

**Requirements**
- Underlying principle is for an entity to assume:
  - maximum possible increase in number of shares for instruments that could be settled by delivering own shares
  - minimum reduction in number of shares for instruments to repurchase own shares
- Disclosures include key terms and conditions relevant to understanding the likelihood of maximum dilution and the possibility for unknown dilution
## Maximum dilution illustrative disclosure

<table>
<thead>
<tr>
<th>Instruments</th>
<th>Maximum number of additional ordinary shares</th>
<th>Key terms and conditions relating to the instrument/transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible bonds B</td>
<td>250</td>
<td>In the event of a change of control of Company X prior to the conversion date, the conversion ratio is adjusted downwards to a pre-determined strike price.</td>
</tr>
<tr>
<td>Convertible bonds D</td>
<td>350</td>
<td>Issuer holds an option to settle in shares or cash (equal to the value of the shares).</td>
</tr>
<tr>
<td>Convertible bonds (A and C)</td>
<td>600</td>
<td>Holder holds an option to convert the bond at a specified conversion date using a specified conversion ratio.</td>
</tr>
<tr>
<td>Instruments</td>
<td>Maximum number of additional ordinary shares</td>
<td>Key terms and conditions relating to the instrument/transaction</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------</td>
<td>---------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Mandatorily convertible note F</td>
<td>100</td>
<td>Subject to a cap of 100 shares and a floor of 10 shares.</td>
</tr>
<tr>
<td>Number of share options in the scope of IFRS 2 outstanding at reporting date</td>
<td>100</td>
<td>Refer to note x (IFRS 2 disclosures on share options).</td>
</tr>
<tr>
<td>Number of known unvested shares from share awards in the scope of IFRS 2 at reporting date</td>
<td>100</td>
<td>Refer to note y (IFRS 2 disclosures on share awards).</td>
</tr>
</tbody>
</table>
### Maximum dilution illustrative disclosure (continued)

<table>
<thead>
<tr>
<th>Instruments</th>
<th>Maximum number of additional ordinary shares</th>
<th>Key terms and conditions relating to the instrument/transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum number of additional ordinary shares</td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>Unknown number of additional ordinary shares</td>
<td>unknown dilution from Share-settled bond E</td>
<td>The number of shares will depend on the share price at settlement date</td>
</tr>
<tr>
<td>Total maximum number of additional ordinary shares</td>
<td>1,500 + unknown dilution from Share-settled Bond E</td>
<td></td>
</tr>
<tr>
<td>Less: minimum reduction in the number of ordinary shares</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share buy-back</td>
<td>(100)</td>
<td>Commitment to buy 100 –500 shares.</td>
</tr>
<tr>
<td>Net maximum number of additional ordinary shares</td>
<td>1,400 + unknown dilution from Share-settled Bond E</td>
<td></td>
</tr>
</tbody>
</table>
OVERVIEW ON FICE

FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

EAA Virtual Research Workshop, 11 March 2024

Sapna Heeralall
DISCLAIMER

The views expressed in this presentation are those of the presenter, except where indicated otherwise. EFRAG positions, as approved by the EFRAG FRB, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.
OVERVIEW

• EFRAG’s draft comment letter
  • Presentation proposals
  • Disclosure proposals
EFRAG’s draft comment letter - Presentation
PRESENTATION PROPOSALS

• EFRAG supports the IASB’s proposals to separately present the amounts attributable to ordinary shareholders from other owners of the parent in the primary financial statements

  • Fundamental for the users of financial statements to have information about multiple equity providers and financial instruments not aggregated in a single line

  • Will help users better understand how the proceeds will be distributed on the sale of a business and evaluate the ordinary shareholders’ value
IMPACT ON PRESENTATION – WRITTEN PUT OPTIONS ON NCI

What is a written put option over non-controlling interest (NCI put)

An instrument that obliges an entity in the consolidated group to purchase shares of its subsidiary that are held by a non-controlling-interest shareholders

Initial recognition

<table>
<thead>
<tr>
<th>IASB proposals</th>
<th>NCI puts are presented on the Balance sheet as a financial liability and also presented as a debit to Parent Equity (gross presentation)</th>
</tr>
</thead>
</table>
| EFRAG’s draft comment letter | • Disagree with the IASB’s proposals regarding presentation of NCI puts as a debit to Parent Equity  
• EFRAG considers that NCI puts should be presented as a debit to Equity relating to NCI  
• Also, the IASB should explore the alternative model to treat contracts meeting the definition of a derivative as stand-alone derivatives (net presentation)  
  • Results in no or limited financial liability and no or limited impact on Parent Equity or NCI equity |
### IMPACT ON PRESENTATION – WRITTEN PUT OPTIONS ON NCI

#### Subsequent measurement

<table>
<thead>
<tr>
<th>IASB proposals</th>
<th>Changes in the financial liability are presented in the Statement of profit or loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>EFRAG’s draft comment letter</td>
<td>• Many stakeholders disagree with the resulting presentation in the Statement of profit or loss</td>
</tr>
<tr>
<td></td>
<td>• Would be in conflict with the requirements to account in equity for transactions with owners in their capacity as owners</td>
</tr>
<tr>
<td></td>
<td>• Would be counterintuitive to have measurement changes being presented in profit or loss because performance decreases when the value of the shares subject to the put option increases, and vice versa</td>
</tr>
</tbody>
</table>
EFRAG’s draft comment letter - Disclosures
EFRAG welcomes the improvements to disclosures on issued instruments

Field-testing will be essential to ensure that these disclosures are:

- Clear
- Able to be implemented by entities
- Balanced between the benefits to users and the costs for preparers

EFRAG has the following concerns and suggestions:

1. Disclosures on contractual nature and priority on liquidation.
   - Entities may face challenges in determining whether priority on liquidation stems from contracts or law/regulation.
   - Suggest to provide information on subgroups located in different jurisdictions and on how the group structure affects priority on liquidation.

2. On terms and conditions of financial instruments with both financial liability and equity characteristics disclosures.
   - Useful to provide disclosures on the effects of law on classification as financial liabilities or equity instruments.
**DISCLOSURE PROPOSAL ON RECLASSIFICATION**

<table>
<thead>
<tr>
<th>IASB proposals</th>
<th>Disclosures on terms and conditions that become, or stop being, effective with the passage of time</th>
</tr>
</thead>
<tbody>
<tr>
<td>EFRAG’s draft comment letter</td>
<td>EFRAG expresses concerns on the prohibition to reclassify ‘passage-of-time changes’ while requiring disclosures on terms and conditions that become, or stop being, effective with the passage of time</td>
</tr>
</tbody>
</table>

- Would reflect the substance of the contractual terms for the remaining life of the instruments
- If disclosure is useful for users, why is it not relevant that the instrument be reclassified
APPENDIX:
IMPACT ON PRESENTATION
– WRITTEN PUT OPTIONS
ON NCI
IMPACT ON PRESENTATION – WRITTEN PUT OPTIONS ON NCI

Simplified fact pattern

• The parent owns 70% of the subsidiary

• The value of 100% of the subsidiary’s net assets is CU 1,000, of which CU 700 represents the parent’s share and CU 300 represents the non-controlling interest’s share

• The parent writes a put option which allows the non-controlling shareholder to sell its holding to the parent. The discounted value of this put option’s exercise price is 350 at its issuance (T0) and 400 1 year later (T1)

• The subsidiary’s results in year 1 is CU 100, of which CU 70 represents the parent’s share and CU 30 represents the non-controlling interests share
## IMPACT ON PRESENTATION – WRITTEN PUT OPTIONS ON NCI

**Summary of three approaches**

<table>
<thead>
<tr>
<th></th>
<th>Approach 1</th>
<th>Approach 2</th>
<th>Approach 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance sheet @ T1</strong></td>
<td>(IASB proposal - Debit Parent Equity at T0 and liability changes to P&amp;L)</td>
<td>(Alternative - Debit Equity NCI at T0 and liability changes to parent equity)</td>
<td>(net presentation)</td>
</tr>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net assets - subsidiary</td>
<td>1.100</td>
<td>1.100</td>
<td>1.100</td>
</tr>
<tr>
<td><strong>Liabilities:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial liability</td>
<td>400</td>
<td>400</td>
<td>0</td>
</tr>
<tr>
<td><strong>Equity:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity - parent</td>
<td>370</td>
<td>720</td>
<td>770</td>
</tr>
<tr>
<td>Equity - NCI</td>
<td>330</td>
<td>-20</td>
<td>330</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>1100</td>
<td>1100</td>
<td>1100</td>
</tr>
<tr>
<td><strong>Profit of loss in Y1</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Parent share</td>
<td>20</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>NCI share</td>
<td>30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>50</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>
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EAA Reporting Standards Workshop on FICE

Tobias Bornemann
1. Overview
Overview

- **Focus on the empirical evidence around two leading questions:**
  1. Classification: Do users of financial statements “look through” the accounting classification of HFIs?
  2. Disclosure and presentation: Which features are important to users of financial statements?

- **Not covered, but important in the literature:**
  Effect of classification principles on firms’ decision to issue certain types of HFIs or structuring of HFIs
  Fargher, Sidhu, Tarca, and van Zyl (2019, AF)
HFIs: CHB market

Volume by year

Volume by industry

~ USD 330bn market

Source: Bornemann and Novotny-Farkas (2024, WP)
2. Classification

Do users of financial statements “look through” the accounting classification of HFIs?
Market perception of HFIs: Introduction

- How do capital markets perceive HFIs? As debt, equity, or something in between?
- Underlying idea: Analyze the economic substance of HFIs to classify them as either liabilities or equity
- Example:

  - Necessary condition: Users of financial statements are able to "look through" the label and correctly incorporate the underlying features of HFIs
1. Some evidence that users are able to “look through” the classification of (hybrid) financial instruments
   - Mandatorily Redeemable Preferred Stock (MRPS) does not exhibit a debt-like or equity-like relation with systematic risk or price
     Kimmel and Warfield (1995, TAR); Cheng, Frischmann, and Warfield (2003, RAR)
   - Employee stock options (ESOPs) are negatively correlated to common equity risk and expected returns, suggesting that ESOPs are not priced as liabilities
     Barth, Hodder, and Stubben (2013, RAST)
   - Cash and share-put warrants are priced as debt or equity in line with their solvency characteristics and independent of their accounting classification as liabilities (SFAS 150)
     Terando, Shaw, and Smith (2007, RQFA)
   - In an experiment, experienced finance professionals rely on HFIs’ contractual features when evaluating a firm’s creditworthiness and in their lending decisions
     Clor-Proell, Koonce, and White (2016, JAR)
Market perception of HFIs: Evidence II

2. A bit of evidence suggesting users price HFIs in line with their classification
   - Buy-side analysts price MRPS in line with their accounting classification
     Hopkins (1996, JAR)
   - Markets price perpetual corporate hybrid bonds (PCHBs) as debt around their offering but as equity when presented as equity in F/S
     Bornemann and Novotny-Farkas (2024, WP)
     - Cumulative abnormal returns around PCHB offerings are comparable to straight debt offerings
     - However, the value relevance of PCHBs suggests equity-like pricing when presented in F/S
3. However, the market’s perception is context-specific and likely depends on the attributes of...

a) ... the security
   - Once MRPS includes more equity features (esp., conversion features or voting rights), MRPS is priced more equity-like
     Kimmel and Warfield (1995, TAR)
   - Finance professionals rely on five key features to rank HFIs along the debt-equity continuum: maturity, priority in liquidation, voting rights, settlement in cash or common stock, dependence on profitability
     Clor-Proell, Koonce, and White (2016, JAR)

b) ... the firm
   - Market perception of MRPS as liabilities or equity depends to some extent on firms’ size
     Cheng, Frischmann, and Warfield (2003, RAR)
   - Investors price preferred stock as more equity-like (liabilities-like) when the firm is financially distressed (healthy)
     Linsmeier, Partridge, and Shakespeare (2023, WP)
Classification changes: Evidence

1. No studies that analyze whether reclassifications of (hybrid) financial instruments provide more useful information to users

2. Literature supports that firms adjust financing or instruments in response to classification changes
   a) FAS 150: reclassified MRPS from mezzanine to liabilities around 2003
      - Firms redeemed MRPS early before the adoption of FAS 150 to avoid negative effects on debt covenants
        Moser, Newberry, and Puckett (2011, RAST)
      - Firms issued fewer MRPS and restructured MRPS after the adoption of FAS 150
        Levi and Segal (2015, EAR); Hanlon (2019, AJM)
   b) IAS 32: reclassified most preferred shares from equity to liabilities
      - Majority of affected firms either buy back or restructure preferred shares in response to IAS 32
        De Jong, Rosellón, and Verwijmeren (2006, AiE)
1. Some evidence that users “look through” the classification of HFIs even in low-disclosure settings (e.g., no information on MRPS’ attributes was disclosed in the analyzed U.S. settings)

2. A bit of evidence that users price HFIs in line with their classification

3. The perception of HFIs as debt-like or equity-like is context-specific and depends on
   - The features of the instrument
   - The economic attributes of the firm
   - (The type of user of financial statements)

4. No evidence that reclassification of (certain) HFIs provides more useful information
2. Presentation and Disclosure

Which features are important to users of financial statements?
Contractual features of HFIs are typically public information after their offering. Nevertheless, disclosure of contractual features in the *Notes to the Financial Statements* can have two effects:

1. reduces information asymmetry across different types of users of financial statements ("levels the playing field")
2. reduces information processing costs of users of financial statements

Blankespoor, deHaan, and Marinovic (2020, JAE)
Disclosure: Anecdotal evidence

- Transparency on perpetual hybrid bonds varies across firms

Source: Bornemann and Novotny-Farkas (2024, WP)
Disclosure: Anecdotal evidence

- Transparency on perpetual corporate hybrid bonds (PCHBs) varies across firms

Lacking disclosures on seniority, voting rights, and dilution effects of PCHBs

Source: Bornemann and Novotny-Farkas (2024, WP)
Disclosure: Evidence

- Some evidence that HFIs’ features differ in their importance to certain users (“experienced finance professionals conducting credit-related judgments”)
  Clor-Proell, Koonce, and White (2016, JAR)
  - Maturity and priority in liquidation matter most in assessing an HFI as equity-like or debt-like
  - Voting rights, settlement in cash or common stock, and dependence on profitability matter less
  - However, no broad agreement on the relative importance of features
  → No evidence that these results generalize to other types of users

- Some descriptive evidence that disclosure guidance improves disclosure of HFI features
  Marquardt and Wiedman (2007, AH)
  - Disclosure of conversion features and impact on diluted EPS was low pre-2004, esp. for firms with high
  - Disclosure of conversion features of COCOs improved after disclosure guidance by FASB in 2004

- Separate presentation of CHBs in F/S is associated with lower forecast error and dispersion of analysts
  Bornemann and Novotny-Farkas (2024, WP)
Differences in disclosure for similar instruments

- Under IFRS 7, no specific disclosures are required for instruments classified as equity

### Hybrid bonds

The hybrid bonds issued by Bayer AG are subordinated, and 50% of their amount is treated by the rating agencies as equity. They therefore have a more limited effect on the Group’s rating-specific debt indicators than senior borrowings.

In 2019, Bayer AG repurchased the €1.75 billion hybrid bond maturing in 2075 (callable on July 1, 2020) before the first call date. The repurchase was financed through the issuance of two hybrid bonds with nominal volumes of €1 billion and €750 million.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Hybrid bond 2014/2024/2074</td>
<td>EUR 1,500 million</td>
<td>1,497</td>
<td>EUR 1,500 million</td>
<td>1,497</td>
</tr>
<tr>
<td>Hybrid bond 2015/2025/2075</td>
<td>EUR 1,300 million</td>
<td>1,298</td>
<td>EUR 1,300 million</td>
<td>1,298</td>
</tr>
<tr>
<td>Hybrid bond 2019/2025/2079</td>
<td>EUR 1,000 million</td>
<td>990</td>
<td>EUR 1,000 million</td>
<td>991</td>
</tr>
<tr>
<td>Hybrid bond 2019/2027/2079</td>
<td>EUR 750 million</td>
<td>746</td>
<td>EUR 750 million</td>
<td>747</td>
</tr>
</tbody>
</table>

Pursuant to IAS 32, the following hybrid bond issued by Group companies must be classified as equity:

<table>
<thead>
<tr>
<th>Hybrid bonds</th>
<th>Nominal value</th>
<th>First call date</th>
<th>Coupon in % p.a.¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>RWE AG</td>
<td>£750 m</td>
<td>2019</td>
<td>7.0</td>
</tr>
</tbody>
</table>

¹ Until the first call date.

Proceeds from the bond issue were reduced by the capital procurement costs and added to equity, taking account of taxes. Interest payments to bondholders will be booked directly against equity, after deduction of taxes. Such payments can be deferred by the company; under certain circumstances, however, they must be made up again, for example if the Executive Board and Supervisory Board propose to the Annual General meeting that a dividend be paid.
Disclosure: Conclusion

- The existing disclosure requirements (e.g. IFRS 7 and IFRS 9) and the complexity of the features of HFIs are unlikely to provide sufficient information to allow users to reclassify instruments (e.g. from debt to equity)

  Fargher, Sidhu, Tarca, and van Zyl (2019, AF)

- However, features are important to allow users to assess the financing of the firm and the characteristics of HFIs

- No consensus on which features matter most to characterize HFIs, but users rely on:
  - Maturity
  - Priority in liquidation
  - Voting rights
  - Settlement in cash or common stock
  - Dependence on profitability
3. Conclusion and Outlook
Conclusion

1. No consistent evidence that the reclassification of certain types of instruments provides more useful information to users
2. Some evidence that users do not assess the same type of instrument consistently
3. Instead, the assessment of HFIs is likely context-specific and relies on the attributes of the instrument and the firm

→ **A dichotomous classification of HFIs does likely not communicate important information relevant to HFIs**

→ **Disclosure of underlying features allows users to (more cost-effectively) evaluate them**
Caveats and outlook

- Existing empirical and experimental evidence is largely limited to
  - U.S. settings
  - specific types of HFIs (mainly MRPS)
  - specific types of users (buy-side analysts, finance professionals making credit-related decisions)
  - sample periods before 2000
  - equity market effects

- Avenues for future research
  - Differences in perception of HFIs across different types of users, esp. less experienced users
  - Differences in perception of HFIs across debt and equity markets
  - Identification of attributes that are important to different users to assess HFIs’ underlying characteristics